Solution 7.1

a.) i) Accounting policies are specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements (IAS 8,p5).

ii) A change in accounting policy shall be made if:
- it is required by IFRS or Interpretation; or
- it results in more reliable and relevant presentation in the financial statements, financial position or financial performance of the entity.

Accounting policies are the principles upon which the presentation of the financial statements are based and therefore applying changes to these accounting policies cannot be made prospectively as it will compromise the comparability and consistency of the financial statements.

A change in accounting policy is therefore applied retrospectively with all prior period comparatives in the set of financial statements being restated and based upon the new policy. All prior periods not given as comparatives must also be adjusted, but with the cumulative effect on the opening balance of retained earnings disclosed as a single adjustment.

Where adjustments to prior periods are impracticable to determine (i.e. the company cannot apply it after making every reasonable attempt to do so), the application of a prospective adjustment may be appropriate.

b.) i) A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present value status of, and the expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from the new information or new developments and, accordingly, are not correction of errors (IAS 8, p5).

ii) A change in accounting estimate relates to the change in the present status of expected future benefits and obligations associated with assets and liabilities. Due to accounting estimates relating to future benefits, a retrospective change would not be appropriate.

The effect of a change in accounting estimate shall therefore be recognised prospectively by including it in profit or loss in
- the period of the change, if that change affects that period only; i.e. the current period; or
- the period of the change and in future periods, if the change affects both.

(IAS 8.36)

To the extent that a change in accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change (IAS 8.37).

c.) i) Errors are omissions from, and misstatements in, the entity's financial statements, and preparation thereof, arising from a failure to use, or misuse, of reliable information that was available or reasonably expected to have been obtained and taken into account.

ii) IAS 8 requires that all material prior period errors are to be corrected retrospectively in the financial statements authorised for issue after their discovery.

Material omissions or misstatements of items are material if they could, individually or collectively; influence the economic decision that users make on the basis of the financial statements (IAS 8.5).

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when the financial statements for those periods were authorised for issue; and
- could reliably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

iii) In order to understand how errors are accounted for we shall break them down into three key areas, namely:

- Errors in the current financial year
- Immaterial errors made in the previous financial years
- Material errors occurring in previous financial years

All errors that occurred during the current year, whether material or immaterial, are adjusted in the current year.

If an error in the previous period is immaterial, it should also be corrected in the current year.

An entity shall correct material prior period errors as this means that previous financial statements that were published were incorrect and therefore need to be restated. Material prior period errors shall be corrected retrospectively.

A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error. When it is impracticable to determine the cumulative effect, at the beginning of the current period, of the error on all prior periods, the entity shall restate the comparative information to correct the error prospectively from the earliest date (IAS 8, p43–45).

Solution 7.2

a)

A change in the method of depreciation from the residual balance method to the straight line method is a change in accounting estimate. It may not be recognised as a change in accounting policy as the policy to depreciate the asset has not changed. It is merely the method of estimating depreciation that has changed.

The depreciation method used must reflect the pattern in which the asset's future economic benefits are expected to be consumed (IAS 16, p60).

When there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method of depreciation must be changed to reflect the changed pattern (e.g. from the residual balance method to the straight line method). Such a change must be accounted for as a change in an accounting estimate in accordance with IAS 8 (IAS 16, p61).

The change in accounting estimate must be applied prospectively. This prospective adjustment may be made using either the reallocation method or the cumulative catch-up method.

b)

A change from the weighted average method to the first-in-first-out method is generally taken to be a change in accounting policy although there is an argument that suggests it could be accounted for as a change in estimate.

Arguments for a change in accounting policy

Accounting policies are specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements (IAS 8, p5).

IAS 8, p35 states that a change in a measurement basis is a change in an accounting policy.

Inventory is valued at the lower of cost and net realisable value. This is referred to in IAS 2 as the measurement basis used for inventory. This is therefore a policy (the basis used in preparing the inventory balance for inclusion in the financial statements).

Part of this measurement basis is the determination of cost. IAS 2 requires that cost be determined according to one of the cost formulae:

- Weighted average
- First-in-first-out
- Specific identification

A change from the weighted average method to the FIFO method of valuing inventory is therefore a change in the cost formula used. Since the cost formula used is simply a part of the measurement basis for inventory, this represents a partial change in the measurement basis – and therefore a change in accounting policy.

Arguments in favour of a change in accounting estimate

A change in accounting estimate is defined as an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present value status of, and the expected future benefits and obligations associated with, assets and liabilities (IAS 8, p5).

A change from weighted average to first-in-first-out method reflects a change in the pattern in which the future economic benefits embodied in inventory are to be expensed.

IAS 8.35 states that when it is difficult to distinguish a change in accounting policy from a change in accounting estimate, the change is treated as a change in accounting estimate. Since there appears to be a lack of consensus regarding whether or not the change from weighted average to first-in-first-out method is a change in policy or change in estimate, this paragraph suggests that it should be accounted for as a change in estimate.

Solution 7.3

a)

CLUEDO LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 20X4 (EXTRACTS)

1. Accounting policies

1.1 Statement of compliance

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation

The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year.

1.3 Non-current assets

Equipment is depreciated using the straight-line method at 10% p.a. This represents a change in estimate, as disclosed in notes 2 and 3.

2. Profit before tax

	20X4	20X3
Profit before tax is arrived at after deducting	C	C
Depreciation - equipment	50 000	100 000
- original estimate	100 000	
- change in estimate (note 3)	(50 000)	

3. Change in estimate

The company changed the estimated useful life of the forensic equipment from six to ten years.

The (increase)/ decrease caused by the change in estimate is as follows:	C
• Current profits (before tax)	(50 000)
• Future profits (before tax)	50 000

Solution 7.3 continued …

b)

i) Depreciation journal:

	Debit	Credit
Depreciation	50 000	
Accumulated depreciation: equipment		50 000
Depreciation of equipment		

ii) Adjustment to depreciation journal:

	Debit	Credit
Accumulated depreciation: equipment	50 000	
Depreciation		50 000
Adjustment to depreciation of equipment		

c)

	Debit	Credit
Tax expense	15 000	
Deferred tax		15 000
Deferred tax resulting from change in estimated depreciation W2		

Workings

W1 Change in accounting estimate (RAM)			**Original estimate**	**Revised estimate**	**Difference**
01/04/X1	Cost	*Given*	600 000		
31/03/X3	Accum. depreciation	*(600 000 / 6 x 2 years)*	(200 000)		
31/03/X3	Carrying amount		400 000	400 000	
	Remaining useful life	*(6 – 2 yrs) (10 – 2 yrs)*	*4 years*	*8 years*	
31/03/X4	Depreciation	*(400 000/ 4) (400 000/ 8)*	(100 000)	(50 000)	
31/03/X4	Carrying amount		300 000	350 000	50 000
Future yrs	Depreciation		(300 000)	(350 000)	(50 000)
Final	Carrying amount	*Residual value*	0	0	0

W2 Deferred tax	**Carrying amount**	**Tax base**	**Temporary difference**	**Deferred tax**	**Adjustment/ balance**
Balance: 1/4/20X1	0	0	0	0	
Purchase	600 000	600 000			
Depreciation (/6)	(100 000)	(100 000)			
Balance: 31/3/20X2	500 000	500 000	0	0	
Depreciation	(100 000)	(100 000)			

(/5)					
Balance: 31/3/20X3	400 000	400 000	0	0	
Depreciation (/8)	(50 000)	(100 000)	(50 000)	(15 000)	Cr DT; Dr TEL
Balance: 31/3/20X3	350 000	300 000	(50 000)	(15 000)	

Solution 7.4

Part a)

i) Disclosure:

DREAMCOAT LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

2 Profit before taxation

Profit before taxation is stated after taking the following (income)/ expenses into account:			20X6 C	20X5 C
Depreciation on vehicles	W1		1 000	900
• original estimate	W1		900	
• change in estimate	W1	3	100	

3 Change in accounting estimate

The residual value of vehicles was changed from C1 000 to C600.

The (increase)/ decrease caused by the change is as follows:	20X6 C
• current profits (before tax)	100
• future profits (before tax)	300

ii) Depreciation journal:

	Debit	Credit
Depreciation	1 000	
Accumulated depreciation: vehicle		1 000
Depreciation of vehicle		

iii) Adjustment to depreciation journal:

	Debit	Credit
Depreciation	100	
Accumulated depreciation: vehicle		100
Adjustment to depreciation of vehicle		

Workings:

W1 Change in accounting estimate (RAM)	Date	Calculations	Was	Is	Adjustment
Cost	1/1/20X0		10 000		
Accum. depreciation	31/12/20X5	(10K – 1K) / 10yrs x 6yrs	(5 400)		
Carrying amount	31/12/20X5		4 600	4 600	
Residual value			*(1 000)*	(600)	
Depreciable amount			*3 600*	*4 000*	
Remaining useful life		*10 – 6 years*	*4 years*	*4 years*	
Depreciation		current year adjustment	(900)	(1 000)	(100)
Carrying amount	31/12/20X6	cumulative adjustment	3 700	3 600	(100)
Depreciation:	future	(CA: 3 700 – RV: 1 000) (CA: 3 600 – RV: 600)	(2 700)	(3 000)	(300)
Carrying amount:	future final	residual value	1 000	600	(400)

Solution 7.4 continued …

Part b)

i) Disclosure:

DREAMCOAT LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

2 Profit before taxation

Profit before taxation is stated after taking the following (income)/ expenses into account:			20X6 C	20X5 C
Depreciation on vehicles	W1		775	900
• original estimate	W1		900	
• change in estimate	W1	3	(125)	

3 Change in accounting estimate

The residual value of vehicles was changed from C1 000 to C1 500.

The (increase)/ decrease caused by the change is as follows:	20X6 C
• current profits (before tax)	(125)
• future profits (before tax)	(375)

ii) Depreciation journal:

	Debit	Credit
Depreciation	775	
Accumulated depreciation: vehicle		775
Depreciation of vehicle		

iii) Adjustment to depreciation journal:

	Debit	Credit
Accumulated depreciation: vehicle	125	
Depreciation		125
Adjustment to depreciation of vehicle		

Workings:

W1 Change in accounting estimate (RAM)	Date	Calculations	Was	Is	Adjustment
Cost	1/1/20X0		10 000		
Accum. depreciation	31/12/20X5	(10K – 1K) / 10yrs x 6yrs	(5 400)		
Carrying amount	31/12/20X5		4 600	4 600	
Residual value			*(1 000)*	*(1 500)*	
Depreciable amount			*3 600*	*3 100*	
Remaining useful life			*4 years*	*4 years*	
Depreciation		current year adjustment	(900)	(775)	125
Carrying amount	31/12/20X6		3 700	3 825	125
Depreciation:	future	(CA: 3 700 – RV: 1 000) (CA: 3 825 – RV: 1 500)	(2 700)	(2 325)	375
Carrying amount:	future final	residual value	1 000	1 500	500

Solution 7.4 continued …

Part c)

i) Disclosure:

DREAMCOAT LIMITED.
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

2 Profit before taxation

Profit before taxation is stated after taking the following (income)/ expenses into account:			20X6 C	20X5 C
Depreciation on vehicles	W1		(0)	900
• original estimate	W1		900	
• change in estimate	W1	3	(900)	

3 Change in accounting estimate

The residual value of vehicles was changed from C1 000 to C5 000.

The (increase)/ decrease caused by the change is as follows:	20X6 C
• current profits (before tax)	(900)
• future profits (before tax)	(2 700)

ii) Depreciation journal:

	Debit	Credit
No journal would be processed.		

iii) Adjustment to depreciation journal:

iii) Adjustment to depreciation journal:	Debit	Credit
Accumulated depreciation: vehicle	900	
Depreciation		900
Adjustment to depreciation of vehicle		

Workings:

W1 Change in accounting estimate (RAM)	Date	Calculations	Was	Is	Adjustment
Cost	1/1/20X0		10 000		
Accumulated depreciation	31/12/20X5	*(10K – 1K) / 10yrs x 6yrs*	(5 400)		
Carrying amount	31/12/20X5		4 600	4 600	
Residual value			*(1 000)*	*(5 000)*	
Depreciable amount			*3 600*	*(400)*	
Remaining useful life		*10 – 6 years*	*4 years*	*4 years*	
Depreciation		*current year adjustment*	(900)	*(0)	*900
Carrying amount	31/12/20X6		3 700	4 600	900
Depreciation:	future	*(CA: 3 700 – RV: 1 000)* *(CA: 5 000 – RV: 5 000)*	(2 700)	(0)	2 700
Carrying amount:	future final	*residual value*	1 000	4 600	3 600

* According to IAS 16, depreciation must cease when the residual value is greater than or equal to the carrying amount. Depreciation will resume when the residual amount drops below the carrying amount IAS 16, p 54.

Solution 7.5

MERIDIAN LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X6

		Note	20X6 C	20X5 C
Revenue	*Given*		800 000	650 000
Profit before tax	*(329 000 – 28 800)*	4	300 200	236 000
Income tax expense	*(131 600 – 28 800 x 40%) or (112 080 + 8 000 + 1 875)*	6	(120 080)	(94 400)
Profit for the period			180 120	141 600
Other comprehensive income			0	0
Total comprehensive income			180 120	141 600

MERIDIAN LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X6

	Retained earnings C
Balance 31/12/20X4	(40 000)
Total comprehensive income: 20X5	141 600
Dividends	(10 000)
Balance 31/12/20X5	91 600
Total comprehensive income: 20X6	180 120
Dividends	(15 000)
Balance 31/12/20X6	256 720

Solution 7.5 continued …

MERIDIAN LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6

1. Accounting policies

1.1 Statement of compliance
These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation
The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year.

1.3 Non-current assets

Plant is depreciated using the straight-line method over its remaining useful life of three years. This represents a change in estimate, as disclosed in note 4 and 5.

4. Profit before tax

	20X6	20X5
Profit before tax is arrived at after deducting:	C	C
Depreciation - plant	80 000	64 000
- original estimate	51 200	
- change in estimate (note 5)	28 800	

5. Change in estimate
The company changed the method of estimating depreciation on plant from the reducing balance to the straight-line method and changed the estimated residual value from C0 to R16 000.

The (increase)/ decrease caused by the change in estimate is as follows:	20X6
	C
• Current profits (before tax)	28 800
• Future profits (before tax)	(44 800)

6. Taxation expense

		20X6	20X5
		C	C
Normal tax			
- Current tax	*20X6 (given – unchanged) or (W3)*	112 080	80 000
- Deferred tax	*20X6 [19 520 – (28 800x40%)] or (W2)*	8 000	14 400
Tax expense		120 080	94 400

Tax rate reconciliation:

Applicable tax rate		40%	40%
N Tax effects of:		C	C
Profit before tax	*(20X5: 236 000 x 40%)* *(20X6: 300 200 x 40%)*	120 080	94 400
Tax expense		120 080	94 400
Effective tax rate	*(20X5: 94 400/ 236 000)*	40.00%	40.00%

(20X6: 120 080 / 300 200)

Solution 7.5 continued…

Workings

W1 Change in estimate – re-allocation method

There are two estimates that have changed:

- The estimated residual value has been changed (from C0 to R16 000); and
- The estimated pattern of consumption of the asset/ method of depreciation (from reducing balance method to straight-line method).

	Date	*Calculations*	**Was**	**Is**	**Difference**
Cost	1/1/20X3		500 000		
Depreciation	20X3	(500 000 x 0.20)	(100 000)		
Carrying amount	31/12/20X3		400 000		
Depreciation	20X4	(400 000 x 0.20)	(80 000)		
Carrying amount	31/12/20X4		320 000		
Depreciation	20X5	(320 000 x 0.20)	(64 000)		
Carrying amount	31/12/20X5		256 000	256 000	
		Residual value	*0*	*(16* 000*)*	
		Depreciable amount	*256 000*	*240* 000	
		Rate or remaining useful life	*20%*	*3 years*	
Depreciation	20X6	(256 000 x 0.20) (240 000 / 3)	(51 200)	(80 000)	(28 800)
Carrying amount	31/12/20X6		204 800	176 000	(28 800)
Depreciation	future	(CA: 256 000 – RV: 0) (CA: 176 000 – RV: 16 000)	(204 800)	(160 000)	44 800
Carrying amount	future/ final		0	16 000	16 000

W2 Calculation of deferred tax (not required)	**Carrying amount**	**Tax base**	**Temporary difference**	**Deferred tax**	
01/01/20X3 opening balance	0	0	0	0	
purchase	500 000	500 000	0	0	
depreciation/ wear & tear	(100 000)	(200 000)	(100 000)	(40 000)	
31/12/20X3 closing balance	400 000	300 000	(100 000)	(40 000)	L
depreciation/ wear & tear	(80 000)	(100 000)	(20 000)	(8 000)	
31/12/20X4 closing balance	320 000	200 000	(120 000)	(48 000)	L
depreciation/ wear & tear	(64 000)	(100 000)	(36 000)	(14 400)	
31/12/20X5 closing balance	256 000	100 000	(156 000)	(62 400)	L
depreciation/ wear & tear	(80 000)	(100 000)	(20 000)	(8 000)	
31/12/20X6 closing balance	176 000	0	(176 000)	(70 400)	L

W3 Tax computation (not required)		**20X6**			**20X5**		
			Tax x 40%	**Journal entry**		**Tax x 40%**	**Journal entry**
Profit before tax	*Per SOCI*	300 200	120 080	Dr TE	236 000	94 400	Dr TE
Temporary differences	*:Deferred tax*	(20 000)	8 000	Cr DT	(36 000)	14 400	Cr DT
+Depreciation		80 000			64 000		
-Tax allowances		(100 000)			(100 000)		
Taxable income	*:Current tax*	280 200	112 080	Cr CTP	200 000	80 000	Cr CTP

Solution 7.6

a) Journals

Adjusting journal:	Debit	Credit
Depreciation	50 000	
Vehicles: accumulated depreciation		50 000
Adjustment to depreciation of vehicles		

For your interest:
Had no entries for depreciation yet been passed in 20X5, the correct journal entry would have been:

Correct depreciation journal:	Debit	Credit
Depreciation	125 000	
Vehicles: accumulated depreciation		125 000
Depreciation of vehicles		

b) Note disclosure

MILD LIMITED.
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5 (EXTRACTS)

1. Accounting Policies

1.1 Statement of compliance
These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation
The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year.

1.3 Depreciation
Vehicles are depreciated over 6 years using the straight-line method. This represents a change in estimate (see notes 2 and 3).

2. Profit before tax

Profit before tax is stated after taking into account the following items:		20X5 C	20X4 C
Depreciation		125 000	75 000
• original estimate		75 000	
• change in estimate	3.	50 000	

3. Change in estimate
The company changed the estimated useful life of vehicles from 8 years to 6 years.

The (increase)/ decrease caused by the change in estimate is as follows:	20X5 C

• current profits	50 000
• future profits	(50 000)

Solution 7.6 continued …

c) Statement of comprehensive income – revised using the reallocation method

MILD LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

			20X5 C	20X4 C
Profit before taxation	*(20X5: 500K-50K)*	2	450 000	650 000
Taxation expense	*(20X5: 180K – 50K x 30%)*		165 000	300 000
Profit for the year			285 000	350 000
Other comprehensive income			0	0
Total comprehensive income			285 000	350 000

d) Statement of financial position – revised using the reallocation method

MILD LIMITED
STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X5 (EXTRACTS)

	Workings	Notes	20X5 C	20X4 C
ASSETS				
Property, plant and equipment	*20X5: W1 = 'is' column* *20X4: W1 = 'was' column*	20	250 000	375 000

Workings

W1 Change in accounting estimate (RAM)	Date	Calculations	Was	Is	Adjustment
Cost:	1/1/20X2	*given*	600 000		
Accumulated depreciation:	31/12/20X4	*was: 600 000 / 8yrs x 3yrs*	(225 000)		
Carrying amount:	31/12/20X4		375 000	375 000	
Remaining useful life		*was: 8 – 3; Is: 6 – 3*	*5 yrs*	*3 yrs*	
Depreciation:	20X5	*was: 375 000 / 5 yrs x 1 yr* *is: 375 000 / 3yrs x 1yr*	(75 000)	(125 000)	(50 000)
Carrying amount:	31/12/20X5		300 000	250 000	(50 000)
Depreciation:	future	*(CA: 300 000 – RV: 0)* *(CA: 250 000 – RV: 0)*	(300 000)	(250 000)	50 000
Carrying amount:	future final	*residual value*	0	0	0

Solution 7.6 ADAPTATION

ADAPTATION of the question:
Repeat parts (a) – (d) assuming that the cumulative catch-up method is used to account for changes in accounting estimates.

a) Journals

Workings

W1 Change in Accounting Estimate (CCUM)	Date	Calculations	Was	Is	Adjustment	
Cost:	1/1/20X2	*given*	600 000	600 000		
Accumulated depreciation:	31/12/20X4	*was: 600 000 / 8yrs x 3yrs* *is: 600 000 / 6 yrs x 3yrs*	(225 000)	(300 000)	(75 000)	*Extra deprec*
Carrying amount:	31/12/20X4		375 000	300 000		
Remaining useful life		*was: 8 – 3; Is: 6 – 3*	*5 yrs*	*3 yrs*		
Depreciation:	20X5	*was: 375 000 / 5yrs* *is: 300 000 / 3 yrs*	(75 000)	(100 000)	(25 000)	*Extra deprec*
Carrying amount:	31/12/20X5	*cumulative adjustment*	300 000	200 000	(100 000)	
Depreciation:	future	*(CA: 300 000 – RV: 0)* *(CA: 200 000 – RV: 0)*	(300 000)	(200 000)	100 000	*Less deprec*
Carrying amount:	future final	*residual value*	0	0	0	

Adjusting journal

	Debit	Credit
Depreciation	100 000	
Accumulated depreciation: vehicles		100 000
Adjustment to depreciation of vehicles		

For your interest: *Had no entries for depreciation yet been passed in 20X5, the correct journal entry would have been:*

	Debit	Credit
Depreciation	175 000	
Accumulated depreciation: vehicles		175 000
Depreciation of vehicles		

b) Note disclosure

SPRING LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X5 (EXTRACTS)

1. Accounting Policies

1.1 Basis of preparation

These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Depreciation

Vehicles are depreciated over 6 years using the straight-line method. This represents a change in estimate (see notes 3 and 4).

Solution 7.6 ADAPTATION continued …

b) Note disclosure continued …

3. Profit before tax

Profit before tax is stated after taking the following items into account:

		20X5 C	20X4 C
Depreciation		175 000	75 000
• original estimate		75 000	
• change in estimate	4	100 000	

4. Change in accounting estimate

The company changed the estimated useful life of vehicles from 8 years to 6 years.

The (increase) / decrease caused by the change in estimate on profit before tax is as follows:	20X5 C
• current profits	(100 000)
• future profits	100 000

c) Statement of comprehensive income – revised using the cumulative catch-up method

SPRING LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

			20X5 C	20X4 C
Profit before taxation	*(20X5: 500K-100K)*	2	400 000	650 000
Income tax expense	*(20X5: 180K – 100K x 30%)*		150 000	300 000
Profit for the period			250 000	350 000
Other comprehensive income			0	0
Total comprehensive income			250 000	350 000

Notice that when adjusting for a change in accounting estimate, there is no change to the prior year figures (the change is adjusted for prospectively). Notice that the tax amount is adjusted by the tax effect of the change in estimate adjustment (i.e. adjustment x tax rate). You must NEVER assume that tax will be 30% of 'profit before tax' because there may be permanent differences, STC and other reconciling items to be taken into consideration.

d) Statement of financial position – revised using the cumulative catch-up method

SPRING LIMITED
STATEMENT OF FINANCIAL POSITION
AT 31 DECEMBER 20X5 (EXTRACTS)

	Workings	Notes	20X5 C	20X4 C
ASSETS				
Property, plant and equipment	*20X5: W1 = 'is' column* *20X4: W1 = 'was' column*	20	200 000	375 000

Solution 7.7

a)

PEAR LIMITED
EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X6

		20X6 C	20X5 C Restated
Profit before tax	(20X6: 500 000 – 150 000) (20X5: 400 000 – 150 000)	350 000	250 000
Income tax expense	[20X6: 145 000 – (150 000 X 0,29)] [20X5: 116 000 – (150 000 X 0,29)]	(101 500)	(72 500)
Profit for the period		248 500	177 500
Other comprehensive income		0	0
Total comprehensive income		248 500	177 500

PEAR LIMITED
EXTRACT FROM THE STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X6

		Note	Retained earnings C
Balance: 01/01/X5 - restated			54 000
- As previously reported			(159 000)
- Correction of error	[600 000 – (600 000 / 4 yrs x 2 yrs)] x 0,71	3	213 000
Total comprehensive income - restated			177 500
Balance: 31/12/X5 - restated			231 500
- As previously reported			125 000
- Correction of error	[213 000 – (150 000 x 0,71)]	3	106 500
Total comprehensive income			248 500
Balance: 31/12/X6			480 000

Solution 7.7 continued …

b)

PEAR LIMITED
EXTRACT FROM THE NOTES TO THE FINANCIAL STATEMENTS
AT 31 DECEMBER 20X6

		20X5 C	20X4 C
3 Correction of error			
The company had incorrectly recorded the acquisition of a vehicle as an expense in a prior year. The effect of the correction of the error is as follows:			
Effect on the statement of comprehensive income			
Increase: depreciation	*(600 000 / 4 yrs)*	150 000	
Decrease: taxation expense	*(150 000 X 0,29)*	(43 500)	
Decrease: profit		106 500	
Effect on the statement of financial position			
Increase: property, plant and equipment	*20X5: [600 000 – (600 000 / 4 yrs X 3 yrs)]* *20X4: [600 000 – (600 000 / 4 yrs X 2 yrs)]*	150 000	300 000
Increase: current tax payable	*20X5: [600 000 - (600 000/ 4 yrs X 3yrs)] X 0,29* *20X4: [600 000 - (600 000/ 4 yrs X 2yrs)] X 0,29*	(43 500)	(87 000)
Increase: retained earnings	*20X5: (expense reversed 600 000 – amortisation to date 600 000 / 4 x 3yrs) x 71%* *20X4: (expense reversed 600 000 – amortisation to date 600 000 / 4 x 2yrs) x 71%*	(106 500)	(213 000)

Solution 7.8

a) Journal

	Debit	Credit
20X7		
Inventory	3 000	
Retained earnings		2 100
Current tax payable		900
Correction of prior period error		

Workings

The journal entry above can be understood by examining the journal entries that *would have been* processed if it were possible to post journal entries to each specific year affected.

	Debit	Credit
Year of inception to 20X5 (prior to the prior year)		
Inventory	2 000	
Cost of sales		2 000
Inventory balance increased: 14 000 - 12 000		
Tax expense	600	
Current tax payable		600
Tax on increased profits: 2 000 x 30%		
20X6 (prior year)		
Cost of sales	1 000	
Inventory		1 000
Inventory balance increased: 15 000 - 14 000 = 1 000 increase		
But increased inventory by 2 000 in past years, therefore:		
1 000 - 2 000 increase in past years = 1 000 decrease		
Current tax payable	300	
Tax expense		300
Tax on decreased profits: 1 000 x 30%		
20X7 (current year)		
Inventory	2 000	
Cost of sales		2 000
Inventory balance increased: 18 000 - 15 000 = 3 000 increase		
But increased inventory by 1 000 in past years (2 000 - 1 000), therefore:		
3 000 - 1 000 increase in past years = 2 000 increase		
Tax expense	600	
Current tax payable		600
Tax on increased profits: 2 000 x 30%		

Solution 7.8 continued

b)

HOT LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X7

		20X7 C	20X6 C Restated
Gross revenue		1 200 000	900 000
Cost of sales	*Journals: (20X7: 420 000 – 2 000) (20X6: 350 000 + 1 000) or W1*	(418 000)	(351 000)
Gross profit		782 000	549 000
Other costs (given)		(220 000)	(200 000)
Profit before tax		562 000	349 000
Income tax expense	*Journals: (20X7: 235 200 + 600) (20X6: 136 500 - 300) or W2*	(235 800)	(136 200)
Profit for the period		326 200	212 800
Other comprehensive income		0	0
Total comprehensive income		326 200	212 800

HOT LIMITED.
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X7 (EXTRACTS)

		Note	Retained earnings C
Opening balance: 1/1/20X6 - restated			68 900
- As previously reported (given)			67 500
- Correction of error	*(14 000 – 12 000) x 70% or W2 or Note: 700 + 700 or Journals: (2 000 – 600)*	4	1 400
Total comprehensive income: 20X6 restated	*213 500 – 700 or per statement of comprehensive income*		212 800
Opening balance: 1/1/20X7 - restated			281 700
- As previously reported (given)			281 000
- Correction of error	*(15 000 – 14 000) x 70% or W2 or per note or Journals: (1 400 – 1 000 + 300)*	4	700
Total comprehensive income: 20X7	*324 800 + 1 400 or per statement of comprehensive income*		326 200
Closing balance: 31/12/20X7			607 900

Solution 7.8 continued

b) continued …

HOT LIMITED.
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X7 (EXTRACTS)

		Notes	20X7 C	20X6 C Restated	20X5 C Restated
ASSETS					
Inventory	*Given*	25	18 000	15 000	14 000
EQUITY AND LIABILITIES					
Retained earnings	*Per statement of changes in equity*		607 900	281 700	68 900

HOT LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X7

1. Accounting policies

1.1 Statement of compliance
These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation
The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year.

1.3 Inventories

Inventories are stated at the lower of cost or net realisable value, with movements recorded on the first-in-first-out method. This represents a correction of error (see note 4).

4. Correction of error

The company had incorrectly recorded inventory movements using the weighted average method instead of the first-in-first-out method.

The effect of this correction is as follows:

Effect on the statement of comprehensive income	**20X6 C**
Increase/ (decrease) in expenses or losses	
Increase in cost of sales	1 000
Decrease in tax expense	(300)
(Increase)/ decrease in income or profits	
Decrease in profit for the year	700

Effect on the statement of financial position	**20X6 C**	**20X5 C**
Increase/ (decrease) in assets		
Increase in inventories	1 000	2 000
(Increase)/ decrease in liabilities and equity		

Increase in current tax payable	(300)	(600)
Increase in retained earnings	(700)	(1 400)

Solution 7.8 continued

b) continued …

Workings

W1 Reconstruction of the inventory accounts	CY	PY	PPY
	Was	**Was**	**Was**
Opening balance (given) (PPY: always zero when starting a business)	14 000	12 000	0
Purchases (balancing figure) *(PPY: assumed figure)*	*421 000*	*352 000*	*100 000*
Closing balance (given)	(15 000)	(14 000)	(12 000)
Cost of sales (given)	420 000	350 000	88 000
	Is	**Is**	**Is**
Opening balance (given) (PPY: always zero when starting a business)	15 000	14 000	0
Purchases (per above working)	421 000	352 000	100 000
Closing balance (given)	(18 000)	(15 000)	(14 000)
Cost of sales (balancing figure)	*418 000*	*351 000*	*86 000*

Abbreviations: CY = current year; PY = prior year; PPY = prior to the prior year

W2 Effect of change on line items:	CY Difference	PY Difference	PPY Difference
Cost of sales increased/ (decreased)	(2 000)	1 000	(2 000)
Profit before tax (increased)/ decreased	(2 000)	1 000	(2 000)
Tax increased/ (decreased)	600	(300)	600
Profit for the year (increased)/ decreased	(1 400)	700	(1 400)
Inventory increased/ (decreased)	3 000	1 000	2 000
Current tax payable (increased)/ decreased	(900)	(300)	(600)
Closing retained earnings (increased)/ decreased	(2 100)	(700)	(1 400)

Abbreviations used:
CY: current year
PY: prior year
PPY: years prior to the prior year

Alternative workings (can replace W1 and W2):

Summary adjustments	Cumulative to 20X7	Profit for 20X7	Cumulative to 20X6	Profit for 20X6	Cumulative to 20X5
WA (old)	15 000		14 000		12 000
FIFO (new)	18 000		15 000		14 000
	(3 000)	(2 000)	(1 000)	1 000	(2 000)
Tax	900	600	300	(300)	600
	(2 100)	(1 400)	(700)	700	(1 400)

Solution 7.8 continued

c)

HOT LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X7

		20X7 C	20X6 C Restated
Revenue		1 200 000	900 000
Cost of sales	*Journals: (20X7: 420 000 – 2 000)* *(20X6: 350 000 + 1 000) or W1*	(418 000)	(351 000)
Gross profit		782 000	549 000
Other costs	*Given*	(220 000)	(200 000)
Profit before tax		562 000	349 000
Income tax expense	*Journals or W2: (20X7: 235 200 + 600)* *(20X6: 136 500 - 300)*	(235 800)	(136 200)
Profit for the period		326 200	212 800
Other comprehensive income		0	0
Total comprehensive income		326 200	212 800

HOT LIMITED.
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X7 (EXTRACTS)

		Note	Retained earnings C
Opening balance: 1/1/20X6 - restated			68 900
- As previously reported	*Given*		67 500
- Change in accounting policy	*(14 000 – 12 000) x 70% or* *W2 or Note: 700 + 700 or* *Journals: (20X7: 2 000 – 600)*	4	1 400
Total comprehensive income: 20X6 restated	*213 500 – 700 or* *per Statement of comprehensive income*		212 800
Opening balance: 1/1/20X7 - restated			281 700
- As previously reported	*Given*		281 000
- Change in accounting policy	*(15 000 – 14 000) x 70% or* *W2 or per note or* *Journals: (1 400 – 1 000 + 300)*	4	700
Total comprehensive income: 20X7	*324 800 + 1 400 or* *per Statement of comprehensive income*		326 200
Closing balance: 31/12/20X7			607 900

Solution 7.8 continued

c) continued ….

HOT LIMITED.
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X7 (EXTRACTS)

		Notes	20X7 C	20X6 C Restated	20X5 C Restated
ASSETS					
Inventory	*Given*	25	18 000	15 000	14 000
EQUITY AND LIABILITIES					
Retained earnings	*Per statement of changes in equity*		607 900	281 700	68 900

HOT LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X7

1. Accounting policies

1.1 Statement of compliance
These financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan. Approved accounting standards comprise of such International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board as are notified under the Companies Ordinance, 198, provisions of and directives issued by under the Companies Ordinance, 1984. In case the requirements differ, the provisions or directives of the Companies Ordinance, 1984 shall prevail.

1.2 Basis of preparation
The financial statements have been prepared on the historical cost convention. The principal accounting policies are set out below. These policies are consistent in all material respects with those applied in the previous year, except the policy concerning the recording of inventory as detailed in note 4.

1.3 Inventories

Inventories are stated at the lower of cost or net realisable value, with movements recorded on the first-in-first-out method. This represents a change in accounting policy (see note 4).

4. Change in accounting policy

The company changed its policy of recording inventory movements using the weighted average method to the first-in-first-out method instead.
This gives relevant and more reliable information in that it better reflects the expected pattern of future economic benefits through usage and sale of inventory. The comparatives have been appropriately restated.

The effect of this change is as follows:

Effect on the statement of comprehensive income	20X7 C	20X6 C
Increase/ (decrease) in expenses or losses		
- Cost of sales	(2 000)	1 000
- Tax expense	600	(300)
(Increase)/ decrease in income or profits		
- Profit for the year	(1 400)	700

Effect on the statement of financial position	20X7 C	20X6 C	20X5 C
Increase/ (decrease) in assets			
- Inventories	3 000	1 000	2 000

(Increase)/ decrease in liabilities and equity			
- Current tax payable	(900)	(300)	(600)
- Retained earnings - closing	(2 100)	(700)	(1 400)

Solution 7.9

a)

Change in accounting estimate (RAM)			Was	Is	Difference
Cost	*1/1/20X0*		250 000		
	31/12/20X2	*(250K - 5K)/10yrs x 3yrs*	(73 500)		
Carrying amount	*1/1/20X3*		176 500	176 500	
Residual value			*(5 000)*	*(10 000)*	
Depreciable amount			*171 500*	*166 500*	
Remaining useful life		*was: 10 - 3; is 15 - 3*	*7*	*12*	
Depreciation	*20X3*		(24 500)	(13 875)	10 625
Carrying amount	*31/12/20X3*		152 000	162 625	
Depreciation	*future*		(147 000)	(152 625)	(5 625)
Carrying amount	*future*	*residual value*	5 000	10 000	5 000

b)

ORANGES LTD
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X3

5. Change in accounting estimate

The residual value of machinery was increased (from C5 000 to C10 000) and the useful life was increased (from 10 years to 15 years).

The (increase)/ decrease caused by the change in estimate is as follows:

	20X3
	C
Current profits	(10 625)
Future profits	5 625
	(5 000)

6. Correction of material error

Cost of sales was incorrectly recognised as equipment during 20X1.

Effect on the statement of comprehensive income		**20X2**
		C
Increase/ (decrease) in expenses or losses		
- Depreciation		(30 000)
- Tax expense	*30 000 x 30%*	9 000
(Increase)/ decrease in income or profits		
- Profit for the year		(21 000)

Effect on the statement of financial position		**20X2**	**20X1**
Increase/ (decrease) in assets		**C**	**C**
Property, plant and equipment	*20X2: 300 000 - (300 000 x 10% x 1.5 years)* *20X1: 300 000 – (300 000 x 10% x 0.5 years)*	(255 000)	(285 000)
(Increase)/ decrease in liabilities			
Deferred tax liability	*20X2: 255 000 x 30%* *20X1: 285 000 x 30%*	76 500	85 500
(Increase)/ decrease in equity			

Retained earnings	*20X2: [300 000 – (300 000 x 10%x1.5)]x70%* *20X1: [300 000 – (300 000 x 10%x0.5)]x70%* *OR balancing*	178 500	199 500

Solution 7.9 continued …

b) continued …

ORANGES LTD
STATEMENT OF COMPREHENSIVE INCOME (EXTRACTS)
FOR THE YEAR ENDED 31 DECEMBER 20X3

	Calculations	20X3 C	20X2 Restated C
Profit before taxation	*20X3: 300 000 + 10 625 deprec estimate+ 30 000depr error corrected* *20X2: 250 000 + 30 000 depr error restatement*	340 625	280 000
Taxation expense	*20X3: 80 000 + 3 188 + 9 000* *20X2: 70 000 + 9 000*	(92 188)	(79 000)
Profit for the year		248 437	201 000
Other comprehensive income		0	0
Total comprehensive income		248 437	201 000

ORANGES LTD
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X3

	Calculations		Retained earnings C
Balance: 1/1/20X2 - restated			800 500
- As previously reported	*given*		1 000 000
- Correction of material error	*(300 000 – 15 000) x 70% or note: 178 500 – (- 21 000)*	6	(199 500)
Total comprehensive income: 20X2 - restated			201 000
Balance: 1/1/20X3 - restated			1 001 500
- As previously reported	*1 000 000 + 180 000*		1 180 000
- Correction of material error	*199 500 – (30 000 x 70%) or note*	6	(178 500)
Total comprehensive income: 20X3			248 437
Balance: 31/12/20X3			1249 937

Solution 7.9 continued …

b) continued …

ORANGES LTD
DRAFT EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X3

		20X3 C	20X2 C Restated	20X1 C Restated
Property, plant and equipment	*Draft SOFP adjusted by note/ jnl 20X1: 1 566 000 – 285 00: note 20X2: 1 391 500 – 255 000: note 20X3: 1 217 000 – 255 000: note + 30 000: correction of error jnl in CY + 10 625: change in estimate jnl in CY*	1 002 625	1 136 500	1 281 000
Retained earnings	*Statement of changes in equity*	1 249 937	1 001 500	800 500
Deferred tax liability	*Draft SOFP adjusted by note/ jnl 20X1: 170 000 – 85 500: note 20X2: 150 000 – 76 500: note 20X3: 140 000 – 76 500: note + 9 000: correction of error jnl in CY + 3 188: change in estimate jnl in CY*	75 688	73 500	84 500

Solution 7.9 continued …

c)

	Debit	Credit
20X3		
Retained earnings (closing balance in 20X2)	178 500	
Equipment: cost		300 000
Equipment: accumulated depreciation	45 000	
Deferred tax	76 500	
Correcting journal entry: effect on years before 20X3 (see W1 for proof that the tax adjustment is DT not CTP)		
Machinery: accumulated depreciation	10 625	
Depreciation		10 625
Taxation expense	3 187.50	
Deferred tax		3 187.50
Adjusting journal entry (change in estimate)		
Equipment accumulated depreciation	30 000	
Depreciation		30 000
Taxation expense	9 000	
Deferred tax		9 000
Correcting journal entry: effect on 20X3		

For interest sake, had one been able to process journals in the previous years of 20X2 and 20X1, the first 'correcting' journal entry shown in 20X3 above would have been replaced with entries made to the specific years affected as follows:

	Debit	Credit
20X1		
Cost of sales	300 000	
Equipment: cost		300 000
Correcting journal entry: 20X1		
Equipment: accumulated depreciation	15 000	
Depreciation		15 000
Correcting journal entry: 20X1 Reversal of depreciation on equipment: 300 000 x 10% x 0.5 year		
Deferred tax	85 500	
Taxation expense		85 500
Correcting journal entry: tax effect on decreased profit in 20X1: (300 000 – 15 000) x 30%		
20X2		
Equipment: accumulated depreciation	30 000	
Depreciation		30 000
Correcting journal entry: 20X2 Reversal of depreciation on equipment: 300 000 x 10% x 1 years		
Taxation expense	9 000	
Deferred tax		9 000
Correcting journal entry: tax effect on increased profit in 20X2: 30 000 x 30%		

Solution 7.9 continued …

c) continued …

Workings

W1. Proof that the tax adjustment is a deferred tax adjustment

Deferred tax caused by equipment that did not exist	Carrying amount	Tax base	Temporary difference	Deferred tax	Balance or adjustment
Incorrect balances: 31/12/20X2 *(300 000 - 300 000 x 10% x 1.5 yrs)*	255 000	0	(255 000)	(76 500)	L
Correct balances: 31/12/20X2	0	0	0	0	
Adjustment required				76 500	Dr DT; Cr TE

Comment: This required deferred tax adjustment assumes that the correct figures had been submitted for tax purposes. In other words:

- a deduction for cost of sales of C300 000 had been claimed in 20X1 and
- a deduction of wear and tear had been claimed on the correct equipment cost of C1 200 000 in 20X1 and 20X2 (i.e. wear and tear was not claimed on the incorrect cost of C1 500 000).

Solution 7.10

a) Journals

		Debit	Credit
20X6			
Retained earnings	*300 000 x 70*	210 000	
VAT payable	*Given*		300 000
Current tax payable: income tax	*300 000 x 30%*	90 000	
Correction of error made in 20X5			
Depreciation		60 000	
Vehicles: accumulated depreciation			60 000
Change in estimated depreciation: W1 (90 000 – 30 000)			
Deferred tax		18 000	
Tax expense			18 000
Change in estimated depreciation: tax effect of decreased profits: 60 000 x 30%			
Advertising expense		750 000	
Machine: cost			750 000
Machine: accumulated depreciation	*750 000 x 10% x 7/12*	43 750	
Depreciation			43 750
Correction of error made in 20X6: reverse incorrectly capitalised advertising to expense and reverse related depreciation			
Current tax payable: income tax		198 750	
Tax expense			198 750
Correction of error made in 20X6: tax effect of decreased profit: [(750 000 x 20% x 7/12) - 750 000] x 30%			
Deferred tax		13 125	
Tax expense			13 125
Correction of error made in 20X6:			
Tax base was: 750 000 - (750 000 x 20% x 7/12) = 662 500			
Carrying amount was: 750 000 - (750 000 x 10% x 7/12) = 706 250			
DTL was: (662 500 - 706 250) x 30% = 13 125; to be reversed			

For interest sake, had one been able to process journals in the previous year of 20X5, the first 'correcting' journal entry in 20X6 above would have been replaced with the following entries in 20X5:

	Debit	Credit
20X5		
Revenue	300 000	
VAT payable		300 000
Current tax payable: income tax	90 000	
Tax expense		90 000
Correction of error made in 20X5		

Solution 7.10 continued …

b) Disclosure

TRUTH LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X6

		Notes	20X6 C	20X5 C Restated
Revenue	*(20X6: 3 810 000)* *(20X5: 2 600 000 – 300 000)*	3	3 810 000	2 300 000
Other income			250 000	100 000
Cost of sales	*(20X6: 2 280 000 + 143 750 – 43 750)*	1	(2 380 000)	(1 260 000)
Distribution costs	*(20X6: 30 000 + 60 000)*		(90 000)	(30 000)
Administration costs			(150 000)	(150 000)
Other costs	*(W3)*		(1 316 250)	(470 000)
Profit before taxation		4	123 750	490 000
Income tax expense	*(20X6: 252 000 – 198 750 – 13 125 – 18 000)* *(20X5: 207 000 – 90 000)*	7	(22 125)	(117 000)
Profit for the period			101 625	373 000
Other comprehensive income			0	0
Total comprehensive income			101 625	373 000

Please note:

1) *The machinery was used in the manufacturing process and depreciation thereon is therefore capitalised to inventory and ultimately expensed as cost of sales. Since no inventory was on hand at year end, all depreciation on machinery would have been expensed through cost of sales.*
2) *Since the vehicles are delivery vehicles, depreciation thereon is included in distribution costs.*

TRUTH LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

	Notes	Retained earnings C
Balance - 1 January 20X5		900 000
Total comprehensive income: 20X5 - restated		373 000
Balance - 31 December 20X5 - restated		1 273 000
- As previously reported		1 483 000
- Correction of error	6	(210 000)
Total comprehensive income: 20X6		101 625
Balance - 31 December 20X6		1 374 625

Solution 7.10 continued …

b) Disclosure continued …

TRUTH LIMITED.
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS)

3 Revenue

Revenue comprises:

		20X6 C	20X5 C
Sale of goods	X5: 2 600 000 – 300 000	3 810 000	2 300 000

4 Profit before taxation

Profit before taxation is stated after taking the following (income)/ expenses into account:

		20X6 C	20X5 C
Directors' remuneration		150 000	150 000
Depreciation on machinery	*W2 or 143 750 – 43 750*	100 000	100 000
Depreciation on vehicles	*W1*	90 000	30 000
• original estimate	*W1*	30 000	
• change in estimate	*W1*	60 000	
Profit on expropriation of land (tax effect: nil)		(150 000)	
Loss on inventory destroyed in tornado (tax decreased by R39 000)		130 000	
Loss on sale of land (tax effect: nil)		200 000	0

5 Change in accounting estimate

The rate of depreciation on vehicles was changed from 10% pa to 20% pa.

The (increase)/ decrease in profits is as follows:		20X6 C
• current profits before tax	*W1*	60 000
• future profits before tax	*W1*	(60 000)

6 Correction of error

A VAT liability was erroneously recognised as revenue in 20X5.
The effect of the correction is as follows:

	20X5 C
Effect on the statement of comprehensive income	
Increase/ (decrease) in expenses or losses	
Income tax expense	(90 000)
(Increase)/ decrease in income or profits	
Revenue	300 000
Profit	210 000

Effect on the statement of financial position	20X5	20X4
(Increase)/ decrease in liabilities and equity	C	C
VAT payable	(300 000)	0
Income tax payable	90 000	0
Retained earnings	210 000	0

Solution 7.10 continued …

b) Disclosure continued …

TRUTH LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X6 (EXTRACTS) CONTINUED …

			20X6 C	20X5 C
7	**Taxation expense**			
	Normal tax			
	Current tax	*W4*	1 125	78 000
	Deferred tax	*W5: (20X6: 30K - 9K); (20X5: -30K-9K) or W4*	21 000	39 000
	Income tax expense	*W4*	22 125	117 000
	Tax rate reconciliation:			
	Applicable tax rate		30%	30%
	Tax effects of:			
	Profit before tax	*(123 750 x 30%) (490 000 x 30%)*	37 125	147 000
	Profit on expropriation of land	*(150 000 x 30%) (N/A)*	(45 000)	0
	Dividend income	*(100 000 x 30%) (100 000 x 30%)*	(30 000)	(30 000)
	Loss on sale of land	*(200 000 x 30%) (N/A)*	60 000	0
	Income tax expense		22 125	117 000
	Effective tax rate	*(22 125 / 123 750) (117 000 / 490 000)*	17.9%	23.9%

Solution 7.10 continued …

Workings

W1 Change in accounting estimate (RAM)			Was	Is	Difference
Cost	1/7/20X3		300 000		
Accum. Depreciation	31/12/20X5	*(was: 300 000x10%x2.5yrs)*	(75 000)		
Carrying amount	31/12/20X5		225 000	225 000	
Remaining useful life		*(was: 10 yrs – 2.5 yrs)* *(is: 5 yrs – 2.5 yrs)*	*7.5 yrs*	*2.5 yrs*	
Depreciation	20X6	*(was: 225 000 / 7.5)* *(is: 225 000 / 2.5)*	(30 000)	(90 000)	(60 000) *extra depr*
Carrying amount	31/12/20X6		195 000	135 000	
Depreciation:	future	*(CA: 195 000 – RV: 0)* *(CA: 135 000 – RV: 0)*	(195 000)	(135 000)	60 000 *less depr*
Carrying amount:	future final		0	0	0

W2 Correction of error in current year: depreciation – machinery		20X6	20X5
Depreciation - given		143 750	100 000
Depreciation on advertising:	*(750 000 x 10% x 7/12)*	(43 750)	0
		100 000	100 000

W3 Other expenses		20X6	20X5
Given		890 000	750 000
Depreciation on machinery	*Cost of sales*	(143 750)	(100 000)
Depreciation on vehicles	*Distribution costs*	(30 000)	(30 000)
Advertising		750 000	0
Directors remuneration	*Administration costs*	(150 000)	(150 000)
		1 316 250	470 000

W4 Current tax	20X6			20X5		
		x 0.30			x 0.30	
Profit before tax	123 750			490 000		
Permanent differences						
- Profit on expropriation of land	(150 000)					
- Dividend income	(100 000)			(100 000)		
+ Loss on sale of land	200 000					
	73 750	22 125	Dr TE	390 000	117 000	Dr TE
Temporary differences						
	(70 000)	21 000	Cr DT	(130 000)	39 000	Cr DT
+Depreciation (machines)	100 000			100 000		
+Depreciation (vehicles)	90 000			30 000		
- W+T allowance (machines) *	(200 000)			(200 000)		
- W+T allowance (vehicles) **	(60 000)			(60 000)		
Taxable profit / (loss)	3 750	1 125	Cr CTP	260 000	78 000	Cr CTP

** wear and tear on machines: 1 000 000 x 20%*
*** wear and tear on vehicles: 300 000 x 20%*

Solution 7.10 continued …

Workings continued …

W5 Deferred taxation

Machinery	Carrying amount	Tax base	Temporary difference	Deferred taxation	
Cost 1/5/20X4	1 000 000	1 000 000	0	0	
Movement - 20X4	(66 667)	(133 333)	(66 667)	(20 000)	Cr DT Dr Tax
Balance 31/12/20X4	933 333	866 667	(66 667)	(20 000)	DTL
Movement - 20X5	(100 000)	(200 000)	(100 000)	(30 000)	Cr DT Dr Tax
Balance 31/12/20X5	833 333	666 667	(166 667)	(50 000)	DTL
Movement - 20X6	(100 000)	(200 000)	(100 000)	(30 000)	Cr DT Dr Tax
Balance 31/12/20X6	733 333	466 667	(266 667)	(80 000)	DTL

Calculation of depreciation (carrying amount column):

20X4:	1 000 000 x 10% x 8/12	66 667
20X5/6:	1 000 000 x 10%	100 000

Calculation of wear and tear (tax base column):

20X4:	1 000 000 x 20% x 8/12	133 333
20X5/6:	1 000 000 x 20%	200 000

Vehicles	Carrying amount	Tax base	Temporary difference	Deferred taxation	
Cost 1/7/20X3	300 000	300 000	0	0	
Movement - 20X3	(15 000)	(60 000)	(45 000)	(13 500)	Cr DT Dr Tax
Balances 31/12/20X3	285 000	240 000	(45 000)	(13 500)	DTL
Movement - 20X4	(30 000)	(60 000)	(30 000)	(9 000)	Cr DT Dr Tax
Balance 31/12/20X4	255 000	180 000	(75 000)	(22 500)	DTL
Movement - 20X5	(30 000)	(60 000)	(30 000)	(9 000)	Cr DT Dr Tax
Balance 31/12/20X5	225 000	120 000	(105 000)	(31 500)	DTL
Movement - 20X6	(90 000)	(60 000)	30 000	9 000	Dr DT Cr Tax
Balance 31/12/20X6	135 000	60 000	(75 000)	(22 500)	DTL

Calculation of the depreciation (carrying amount column):

20X3: 300 000 x 10% x 6/12	15 000
20X4/5: 300 000 x 10%	30 000
20X6: per profit before tax note or W1: 225 000 – 135 000	90 000

Calculation of wear and tear (tax base column):

20X3: 300 000 x 20% (not apportioned for part of a year)	60 000
20X4/5/6: 300 000 x 20%	60 000

Solution 7.11

a)

Journals		Debit	Credit
20X1			
Amortisation expense	*(600 000 / 15 – 600 000 / 20)*	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	*10 000 x 30% or W1*	3 000	
Tax expense			3 000
Correction of error: 20X1			
20X2			
Amortisation expense	*(600 000 / 15 – 600 000 / 20)*	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	*10 000 x 30% or W1*	3 000	
Tax expense			3 000
Correction of error: 20X2			
20X3			
Amortisation	*(600 000 / 15 – 600 000 / 20)*	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	*10 000 x 30% or W1*	3 000	
Tax expense			3 000
Correction of error: 20X3			
20X4			
Amortisation	*(600 000 / 15 – 600 000 / 20)*	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	*10 000 x30% or W1*	3 000	
Tax expense			3 000
Correction of error: 20X4			

One is often unable to process journals in the prior period, in which case the following journal entries would be required instead:

Journals		Debit	Credit
1 January 20X4			
Retained earnings	*(600 000/ 15 – 600 000/ 20) x70% x3 yrs*	21 000	
Intangible asset: accum. amortisation	*(600 000/ 15 – 600 000/ 20) x 3 yrs*		30 000
Deferred tax	*(600 000/ 15 – 600 000/ 20) x30% x 3yrs*	9 000	
Correction of error: years prior to 20X4			
31 December 20X4			
Amortisation	*(600 000 / 15 – 600 000 / 20) x 1 yr*	10 000	
Intangible asset: accumulated amortisation			10 000
Deferred tax	*10 000 x 30% x 1 yr*	3 000	
Tax expense			3 000
Correction of error: effect on 20X4			

Solution 7.11 continued …

b)

AUTUMN LIMITED
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 20X4

5. Correction of Error

The Guppy Rights have been amortised over a period of 20 years instead of 15 years.
The effect of the correction on the prior year/s is as follows:

Effect on the statement of comprehensive income		**20X3 C**
Increase/ (decrease) in expenses or losses		
- Amortisation	*600K / 20 - 600K / 15*	10 000
- Tax expense	*10 000 x 30%*	(3 000)
(Increase)/ decrease in income or profits		
- Profit for the year	*Balancing*	7 000

Effect on the statement of financial position		**20X3 C**	**20X2 C**
Increase/ (decrease) in assets			
Intangible assets	*20X3: (600K / 20 - 600K / 15) x 3 years* *20X2: (600K / 20 - 600K / 15) x 2 years*	(30 000)	(20 000)
(Increase)/ decrease in liabilities and equity			
Deferred tax liability	*20X3: 30 000 x 30%* *20X2: 20 000 x 30%*	9 000	6 000
Retained earnings		21 000	14 000

AUTUMN LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X4

	comments/ calculations	**Note**	**Retained earnings C**
Balance: 1 January 20X3 - restated			786 000
- As previously reported	*given*		800 000
- Correction of material error	*per note: 21 000 – 7 000 or* *journals: (10 000 – 3 000) x 2 years*	5	(14 000)
Total comprehensive income: 20X3 - restated	*270 000 – 10 000 + 3 000 (jnls)*		263 000
Balance: 1 January 20X4 - restated			1 049 000
- As previously reported	*given*		1 070 000
- Correction of material error	*per note or* *journals: (10 000 – 3 000) x 3 years*	5	(21 000)
Total comprehensive income: 20X4	*370 000 - 10 000 + 3 000 (jnls)*		363 000
Balance: 31 December 20X4			1 412 000

Solution 7.11 continued …

b) continued …

AUTUMN LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X4

		20X4 C	20X3 C Restated	20X2 C Restated
ASSETS	*comments/ calculations*			
Intangible assets	*W1.2*	440 000	480 000	520 000
LIABILITIES AND EQUITY				
Retained earnings	*Per statement of changes in equity*	1 412 000	1 049 000	786 000
Deferred taxation	*W1.2*	24 000	18 000	12 000

Solution 7.11 continued …

Workings

W1 Deferred taxation proof (NOT REQUIRED)
Proof that effect on tax expense was a deferred tax adjustment (as opposed to current tax owing to the tax authorities).
It was not necessary to provide this working, because the tax authority is not interested in the rate at which you believe you should be amortising your asset (he simply grants a tax allowance, in this case, at 10% per annum).

Notice how you can pick up the new, revised balances for the statement of financial position from the 'should be' table.

W1.1: Was	CA	TB	TD	DT	
1/1/20X1	0	0	0	0	
	600 000	600 000		(9 000)	cr DT dr TE
	(30 000)	(60 000)			
31/12/20X1	570 000	540 000	(30 000)	(9 000)	L
	(30 000)	(60 000)		(9 000)	cr DT dr TE
31/12/20X2	540 000	480 000	(60 000)	(18 000)	L
	(30 000)	(60 000)		(9 000)	cr DT dr TE
31/12/20X3	510 000	420 000	(90 000)	(27 000)	L
	(30 000)	(60 000)		(9 000)	cr DT dr TE
31/12/20X4	480 000	360 000	(120 000)	(36 000)	L

W1.2: Should be	CA	TB	TD	DT	
1/1/20X1	0	0	0	0	
	600 000	600 000		(6 000)	cr DT dr TE
	(40 000)	(60 000)			
31/12/20X1	560 000	540 000	(20 000)	(6 000)	L
	(40 000)	(60 000)		(6 000)	cr DT dr TE
31/12/20X2	520 000	480 000	(40 000)	(12 000)	L
	(40 000)	(60 000)		(6 000)	cr DT dr TE
31/12/20X3	480 000	420 000	(60 000)	(18 000)	L
	(40 000)	(60 000)		(6 000)	cr DT dr TE
31/12/20X4	440 000	360 000	(80 000)	(24 000)	L

W1.3: Difference: journal adjustment to be made
The difference between the annual deferred tax adjustments that:
- WERE processed (9 000; cr deferred tax and dr tax expense) and
- SHOULD HAVE BEEN processed (6 000; cr deferred tax and dr tax expense)

shows that a difference of 3 000 (9 000 – 6 000) must be reversed *for each affected year*:
- Adjustment per affected year: (3 000; dr deferred tax and cr tax expense).

Solution 7.12

Part A

(a)	Debit	Credit
Equipment: cost	100	
Equipment: Accumulated depreciation		10
Deferred tax liability		3
Current tax liability		24
Retained earnings		63
Correcting journals: equipment expense one year ago		
	100	100

(b)		
Equipment: cost	100	
Repair expense		100
Depreciation	10	
Equipment: Acc Depreciation		10
Tax expense	27	
Deferred tax liability		3
Current tax liability		24
Correcting journals: equipment expense one year ago		
	137	137

Workings

Current normal tax	Was	S/B	Diff	
Profit before depreciation and repair	2 000	2 000		
Repair	(100)	0		
Depreciation	0	(10)		
Profit before tax	1 900	1 990		
Add back depreciation	0	10		
Less wear and tear	0	(20)		
Taxable profits	1 900	1 980		
	570	594	24	Dr. TE Cr. CTP

Deferred normal tax WAS	CA	TB	TD	DT
O/bal 20X1	0	0	0	0
purchase	0	0		
Depreciation/ w&t	0	0		0
C/bal 20X1	0	0	0	0

Deferred normal tax S/B	CA	TB	TD	DT	
O/bal 20X1	0	0	0	0	
purchase	100	100			
Depreciation/ w&t	(10)	(20)		(3)	Dr. TE Cr DT
c/bal 20X1	90	80	(10)	(3)	

Solution 7.12 continued . . .

Tax expense note	WAS	SHB
SA Normal tax		
- current	570	594
- deferred	0	3
	570	597
	30.0%	30.0%

Profit and loss			
Exp's (2)	xxx	Income (1)	xxx
	xxx		xxx
Tax exp (3)	570	Total b/f (PBT)	1 900
Total c/f	1 330		
	1 900		1 900
RE (4)	1 330	Total b/f (PAT)	1 330
Total c/f	0		
	1 330		1 330
		Total b/f	0

Profit and loss			
Exp's (2)	xxx	Income (1)	xxx
	xxx		xxx
Tax exp (3)	597	Total b/f (PBT)	1 990
Total c/f	1 393		
	1 990		1 990
RE (4)	1 393	Total b/f (PAT)	1 393
Total c/f	0		
	1 393		1 393
		Total b/f	0

Part B

	Debit	Credit
(a)		
Equipment: cost	100	
Equipment: Acc Depreciation		10
Deferred tax liability		0
Current tax liability		27
Retained earnings		63
Correcting journals: equipment expense one year ago		
	100	100
(b)		
Equipment: cost	100	
Repair expense		100
Depreciation	10	
Equipment: Acc Depreciation		10
Tax expense	27	
Deferred tax liability		0
Current tax liability		27
Correcting journals: equipment expense one year ago		
	137	137

Solution 7.12 continued . . .

Current normal tax	Was	S/B	Diff	
Profit before depreciation and repair	2000	2000		
Repair	(100)	0		
Depreciation	0	(10)		
Profit before tax	1900	1990		
Add back depreciation	0	10		
Less wear and tear	0	(10)		
Taxable profits	1900	1990		
	570	597	27	Dr. TE Cr. CTP

Deferred normal tax WAS	CA	TB	TD	DT
O/bal 20X1	0	0	0	0
purchase	0	0		
Depreciation/ w&t	0	0		0
C/bal 20X1	0	0	0	0

Deferred normal tax SHB	CA	TB	TD	DT
O/bal 20X1	0	0	0	0
purchase	100	100		
Depreciation/ w&t	(10)	(10)		3
c/bal 20X1	90	90	0	3

Tax expense note	WAS	SHB
SA Normal tax		
- current	570	597
- deferred	0	0
	570	597
	30.0%	30.0%

Profit and loss account			
Exp's (2)	xxx	Income (1)	xxx
	xxx		xxx
Tax exp (3)	570	Total b/f (PB4T)	1 900
Total c/f	1 330		
	1 900		1 900
RE (4)	1 330	Total b/f (PAT)	1 330
Total c/f	0		
	1 330		1 330
		Total b/f	0

Profit and loss account			
Exp's (2)	xxx	Income (1)	xxx
	xxx		xxx
Tax exp (3)	597	Total b/f (PB4T)	1 990
Total c/f	1 393		
	1 990		1 990
RE (4)	1 393	Total b/f (PAT)	1 393
Total c/f	0		
	1 393		1 393
		Total b/f	0

Solution 7.12 continued . . .

Part C

	Debit	Credit
(a)		
Equipment: cost	100	
Equipment: Acc Depreciation		10
Deferred tax liability		27
Current tax liability		0
Retained earnings		63
Correcting journals: equipment expense one year ago		
	100	100
(b)		
Equipment: cost	100	
Repair expense		100
Depreciation	10	
Equipment: Acc Depreciation		10
Tax expense	27	
Deferred tax liability		27
Current tax liability		0
Correcting journals: equipment expense one year ago		
	137	137

Workings

Current normal tax	Was	S/B	Diff
Profit before depreciation and repair	2000	2000	
Repair	(100)	0	
Depreciation	0	(10)	
Profit before tax	1900	1990	
Add back repair	100		
Add back depreciation	0	10	
Less wear and tear	(10)	(10)	
Taxable profits	1990	1990	
	597	597	0

Solution 7.12 continued . . .

Deferred normal tax WAS	CA	TB	TD	DT	
O/bal 20X1	0	0	0	0	
Purchase	0	100			
Depreciation/ w&t	0	(10)		27	Dr. DT Cr.TE
C/bal 20X1	0	90	90	27	A

Deferred normal tax SHB	CA	TB	TD	DT
O/bal 20X1	0	0	0	0
Purchase	100	100		
Depreciation/ w&t	(10)	(10)		0
c/bal 20X1	90	90	0	0

Tax expense note	WAS	S/B
SA Normal tax		
- current	597	597
- deferred	(27)	0
	570	597
	30.0%	30.0%

Profit and loss account			
Exp's (2)	xxx	Income (1)	xxx
	xxx		xxx
Tax exp (3)	570	Total b/f (PB4T)	1 900
Total c/f	1 330		
	1 900		1 900
RE (4)	1 330	Total b/f (PAT)	1 330
Total c/f	0		
	1 330		1 330
		Total b/f	0

Profit and loss account			
Exp's (2)	xxx	Income (1)	xxx
	xxx		xxx
Tax exp (3)	597	Total b/f (PB4T)	1 990
Total c/f	1 393		
	1 990		1 990
RE (4)	1 393	Total b/f (PAT)	1 393
Total c/f	0		
	1 393		1 393
		Total b/f	0